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In the Supreme Court of the United States

Supreme Court, U.S.
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OCTOBER TERM, 1970

No. 998

SECURITY PACIFIC NATIONAL BANK,
Petitioner,

vs.

ALMA M. MYERS and MYRTLE G. CROMWELL, as Executrices of the Will and Estate of Ethel I. Bumbaugh, STEVEN G. OPTON, LAWRENCE and ELISABETH NORMAN, W. H. DRAPER, JR., W. W. WEETH, ISI CORPORATION, R. L. MCKEE, E. R. FOLEY and ELWOOD MURPHEY,
Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

WILLIAM W SCHWARZER
601 California Street
San Francisco, California 94108
Attorney for Petitioner

Of Counsel:
BRENT M. ABEL
JOHN R. REESE
MCCUTCHEN, DOYLE, BROWN & ENERSEN

GOES PRINTING COMPANY OF CALIFORNIA, 540 FIRST STREET, SAN FRANCISCO 94105

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Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

Petitioner Security Pacific National Bank (formerly Pacific National Bank of San Francisco) petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered August 28, 1970, in *Lawrence and Elizabeth Norman v. R. L. McKee, et al.*, No. 23,489, 23,548 and 23,582, all consolidated below.

OPINIONS BELOW

The opinion of the Court of Appeals is not yet reported in F.2d but is reported (without a later modification) at 1970 Federal Securities Law Reports ¶ 92,880, and a copy is attached as Appendix A. The opinion of the District Court is reported at 290 F.Supp. 29, and a copy is attached as Appendix B.

JURISDICTION

The judgment of the Court of Appeals was entered on August 28, 1970. No petition for rehearing has been filed. This Court has jurisdiction under Sec. 1254(1), Title 28, United States Code.

QUESTION PRESENTED

Did the Court of Appeals err in holding that the District Court, in passing on a proposed compromise of a class action under Rules 23(e) and 23.1 of the Federal Rules of Civil Procedure, may base its determination on a balancing of the amount of the settlement against the *amount* of plaintiffs' claims rather than against their *merits* and the prospects of their success.

STATUTORY PROVISIONS INVOLVED

The provisions involved are Rules 23(e) and 23.1 of the Federal Rules of Civil Procedure (383 U.S. at 1050).

Rule 23(e):

> "A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs."

Rule 23.1:

> "In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be as-

> serted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

STATEMENT OF THE CASE AND PROCEEDINGS BELOW

The complaint was filed on May 9, 1966, by two investors in the Insurance Securities Trust Fund ("Fund") derivatively on behalf of the Fund and representatively on behalf of other investors in the Fund. Federal jurisdiction was premised upon alleged violations of the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.* The basic charges were that Insurance & Securities, Inc., ("ISI") unlawfully collected brokerage fees on transactions by the Fund, management fees for its management of the Fund and creation fees on its sale of participating interests in the Fund to investors. Petitioner's predecessor, Pacific National Bank of San Francisco, which acted in the capacity of custodian of the Fund, was named as a nominal defendant; there were no charging allegations against it.

On February 21, 1968, following extensive discovery and negotiations, the parties executed a "Stipulation of Settlement and Compromise" by which ISI agreed to substantial reductions in its fees. Under Rules 23(e) and 23.1 of the Federal Rules of Civil Procedure an action may not be dismissed or compromised without approval of the court, and the Stipulation of Settlement and Compromise was therefore made contingent upon such approval. The District Court denied approval to the settlement agreement and the Court of Appeals affirmed.

Review is sought here of the standard which the District Court employed, and the Court of Appeals affirmed, in passing on and disapproving the settlement.

REASONS FOR GRANTING THE WRIT

This case presents an important question under Rules 23 and 23.1 of the Federal Rules of Civil Procedure. A vast and constantly increasing volume of litigation in the Federal Courts is brought as class actions under these Rules.[1] Rule 23(e) and Rule 23.1 preclude dismissal or compromise of these actions "without the approval of the court."

With the federal courts already straining under a staggering case load,[2] confusion and uncertainty about settlement criteria are an obstacle to the disposition of cases by compromise and voluntary dismissal. Such confusion and uncertainty, obstructing, as they do, the process of settlement and compromise, are costly in any case. In the case of class actions, the adverse effect is enormously multiplied because such actions, by their very nature, tend to impose the greatest burdens on courts and litigants alike.

The purpose of the approval requirement of Rules 23(e) and 23.1 is, of course, to assure fair treatment to the members of the

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[1]See Appendix C.

[2]See Appendix C.

class, particularly those who are absent but would be bound by the disposition of the action.

To enable litigants to achieve that purpose in a manner consistent with the policy favoring settlement, and with the compelling necessity to manage the business of the courts, clarification of the standards to guide the District Courts in passing on settlements is essential. *Cf., Schlagenhauf v. Holder*, 379 U.S. 104, 112 (1964).

The decision of the Court of Appeals in the case at bar approved a standard which not only is confusing and in conflict with prior law, but which would render the compromise and termination of many class actions virtually impossible.

The question presented in this case is directly analogous to that presented in *Protective Committee v. Anderson*, 390 U.S. 414 (1968). There the question was whether the District Court proceeded erroneously in approving a compromise of claims against a debtor in reorganization under Chapter X of the Bankruptcy Act. The law required that the court determine whether the compromise was "fair and equitable." This Court granted certiorari, reversed the judgment below and held that a determination of whether a compromise is "fair and equitable" requires the District Court to "compare the terms of the compromise with the likely rewards of litigation." (390 U.S. at pp. 425, 440) The Court stated that

> "The record before us leaves us completely uninformed as to whether the trial court ever evaluated the merits of the causes of actions held by the debtor, the prospects and problems of litigating those claims, or the fairness of the terms of compromise." (390 U.S. at p. 440)

In the instant case, just as in *Anderson*, the District Court acted on the compromise without ever having "evaluated the merits of the causes of action" or "the prospects and problems of litigating

those claims". The Court of Appeals approved the District Court's procedure, stating

> "Appellants contend that the district judge abused his discretion by failing to directly balance the merits of plaintiffs' claims against the benefits of settlement. We do not agree. Since the exercise of discretion involves essentially a question of fairness, the district judge was entitled to view with more weight *the balance between what plaintiffs sought in their complaint and what the settlement provided.*" (App. A, p. 9) (emphasis added)

Thus, the Court of Appeals has told the District Courts that the fairness of compromises is properly measured not by the merits of the claim but by its alleged magnitude. This is the first Court of Appeals decision squarely on the point. It is a departure from all prior District Court decisions, all of which have applied a standard of judgment similar to that set forth in this Court's decision in *Anderson*, above. See *Glicken v. Bradford*, 35 F.R.D. 144 (S.D.N.Y. 1964); *Schleiff v. Chesapeake & O. Ry. Co.*, 43 F.R.D. 175 (S.D.N.Y. 1967); *Winkelman v. General Motors Corp.*, 48 F. Supp. 490 (S.D.N.Y. 1942); *Fielding v. Allen*, 99 F. Supp. 137 (S.D.N.Y. 1951); *cf. Dann v. Chrysler Corp*, 198 A.2d 185, 201 (Del. Ch. 1963), *aff'd sub nom, Hoffman v. Dann*, 205 A.2d 343 (Del. 1964), *cert. denied*, 380 U.S. 973 (1965). And it creates a conflict with this Court's decision in *Anderson*.

There is a further vice inherent in the Court of Appeals decision. The Court approved the action of the District Court in disregarding all those benefits conferred on plaintiffs as a result of the concurrent settlement between ISI and the SEC. (App. A, p. 9) Thus, the Court has announced a rule in effect requiring double payment by defendants who wish to settle concurrently with public agencies and private parties. The result is further to chill efforts to settle class actions of this nature and to force defendants to litigate to the bitter end.

What this Court does about this case will therefore be closely watched by the federal bench and a large segment of the bar, to all of whom the matter of disposing of class actions and administrative enforcement proceedings is of vital and immediate interest.

And what this Court does—or does not do—about this case will have an enormous impact on litigation pending in the federal courts. That is true first, because of the pervasive use of the class action device in all types of federal litigation, including Securities Act, antitrust, environmental and many other types of cases, and second, because of the prevailing assertion of large damage claims that are not liquidated or objectively determinable.

If the Court permits the Court of Appeals decision to stand, the District Courts will be free to pass on the fairness of settlements on the basis of the unsupported, unproved prayer of the complaint which often reflects dreams more than facts. Moreover, it will open the way to just the kind of situation this Court condemned in *Anderson:*

> "If the quoted statement of the trial court had been the result of an adequate and intelligent consideration of the merits of the claims, the difficulties of pursuing them, the potential harm to the debtor's estate caused by delay, and the fairness of the terms of settlement, then it would without question have been justifiable to approve the proposed compromises. It is essential, however, that a reviewing court have some basis for distinguishing between well-reasoned conclusions arrived at after a comprehensive consideration of all relevant factors, and mere boiler-plate approval phrased in appropriate language but unsupported by evaluation of the facts or analysis of the law. Here there is no explanation of how the strengths and weaknesses of the debtor's causes of action were evaluated or upon what grounds it was concluded that a settlement which allowed the creditor's claims in major part was 'fair and equitable.' " (390 U.S. at p. 434)

Similarly, in the instant case, there is no record of any "comprehensive consideration of all relevant factors" by the District Court, or of "how the strengths and weaknesses of the . . . causes of action were evaluated".

CONCLUSION

For the reasons stated, the writ should be granted.

Dated: November 19, 1970.

Respectfully submitted,

WILLIAM W SCHWARZER

BRENT M. ABEL
JOHN R. REESE
McCUTCHEN, DOYLE, BROWN & ENERSEN
Of Counsel

(Appendices Follow)

Appendix A

United States Court of Appeals

for the Ninth Circuit

Lawrence and Elizabeth Norman, *Plaintiffs-Appellees,* vs. R. L. McKee, et al., *Defendants,* R. L. McKee, E. R. Foley, Elwood Murphy, and Insurance & Securities Incorporated, *Defendants-Appellants.*	No. 23,489
Lawrence and Elizabeth Norman, *Plaintiffs-Appellees,* vs. R. L. McKee, et al., *Defendants,* W. W. Weeth, W. H. Draper, Jr., and Pacific National Bank of San Francisco, *Defendants-Appellants.*	No. 23,548
Lawrence and Elizabeth Norman, *Plaintiffs-Appellants,* vs. R. L. McKee, et al., *Defendants-Appellees.*	No. 23,582

Appeal from the United States District Court
for the Northern District of California

Before: Browning and Hufstedler, Circuit Judges, and Battin*, District Judge.

*Honorable James F. Battin, United States District Judge for the District of Montana, sitting by designation.

BATTIN, District Judge:

This is an action against Insurance Securities Trust Fund (hereinafter the Fund), its directors and officers, its trustee, Pacific National Bank, and its underwriter and manager, Insurance and Securities Incorporated (hereinafter ISI). Plaintiffs have been investors in the Fund since 1963. They bring the action derivatively on behalf of the Fund and representatively on behalf of all other investors. The Fund has approximately 175,000 investors. Jurisdiction is invoked under the Investment Company Act of 1940, 15 U.S.C., Section 80, *et seq.*

BACKGROUND OF THE CASE

ISI is the organization responsible for bringing the Fund into existence. It performs three important functions for the Fund: The selection of investments, the sale of new shares, and the execution of portfolio transactions. For the function of investment advisor and manager, it receives a "management" or "advisory" fee. The complaint alleges that this fee for the fiscal year ending in 1965 was $5,369,282. For selling shares, ISI receives a salesman's commission or "creation" fee. For the fiscal year ending in 1965, the complaint alleges that this fee amounted to $11,539,666. For executing portfolio transactions, ISI receives a brokerage fee. For the years 1962 through 1965, it is alleged to total $3,772,000. The total of the fees for the years alleged is $20,680,948. The complaint alleges that the management and creation fees were and are excessive and that ISI has no right to charge any brokerage commission or, in the alternative, that the brokerage commissions were and are excessive. The complaint prays for recovery of the excessive fees.

After extensive discovery, plaintiffs and defendants negotiated a settlement. The settlement provided for a new schedule of management fees at lower rates to be applicable for a ten-year period. The creation fee on new investments would be reduced

for ten years from 8.85% of the sale price of a new certificate to 8.8%. The settlement provided that brokerage commissions received after July 1, 1967, would be restored to the Fund so far as those charges exceed ISI's cost of performing brokerage service and that brokerage service for a period of ten years would be performed at cost. Because the suit was brought both derivatively and as a class action, court approval of the settlement was necessary under Rules 23.1 and 23(e), F.R.Civ.P. The district court issued an order to show cause why the settlement should not be allowed and notice was given to the investors in the Fund. Hearings were held in April and May, 1968. At least two investors appeared in opposition to the settlement. Before concluding the hearings, the court invited a statement from the Securities and Exchange Commission which responded by filing a brief as *amicus curiae*. By order dated July 29, 1968, the district court ordered "that the proposed settlement, as now presented, be disapproved." The named plaintiffs and defendants appealed. Appellees are investors who appeared in opposition to the settlement.

The district judge found that the proposed settlement was "so inadequate, and, therefore, so unfair that it should not receive judicial approval." With regard to the management fees, plaintiffs predicted that the new schedule would reduce such fees by about $3.5 million over the ten-year period. The new schedule would be applicable only to new certificates. The district court reasoned, therefore, that only future investors would benefit from the new schedule and not the present investors who sought recovery of excess management fees. The creation fee was charged on the sale of a new certificate or the reinvestment of a matured certificate in a new certificate. Plaintiffs predicted that the new rates in the settlement would reduce such fees by $5 million over the ten-year period. Before the settlement offer was made, the SEC adopted a rule prohibiting creation fees when the pro-

ceeds of a matured certificate are reinvested in a new certificate. The district court reasoned that ISI's offer to waive reinvestment creation fees in the future was no consideration, and that, with regard to new investments, the settlement would not benefit the present investors who sought to recover excessive creation fees. Further, as to both management and creation fees, the court pointed out the view of the SEC that such fees were not charged against the Fund but are paid by an investor when he purchases a certificate. Since the settlement waived claims for past improper charges, it would not benefit former and present investors who had already paid the fees and who may seek to recover the excessive fees in an individual action.

Approximately one month before the settlement here was proposed to the court, the SEC and ISI reached a settlement of an action pending before the SEC. With regard to brokerage fees under that settlement, ISI was ordered to refund the amount of fees charged after July 1, 1967, and to begin performing brokerage services at cost for an indefinite time. The district court found that the settlement of brokerage fees did not benefit the Fund or its investors since ISI had only offered to do for ten years what the SEC had already ordered it to do indefinitely.

Two questions are presented by this appeal: (1) Whether an order disapproving a proposed settlement of a class action or a stockholder's derivative suit is appealable as a "final" order, and (2) whether the district judge abused his discretion in disapproving the settlement. We hold that the order is appealable and that the district judge acted within the bounds of his discretion.

APPEAL

Paul F. Geerlings, an Appellee, filed a motion to dismiss the appeal. Appellants ISI, McKee, Foley, and Murphy argue in their brief that Geerlings has no standing to appear against

ISI since he was employed as ISI's Associate General Counsel while this suit was pending. We agree. Appellants point out that Geerlings was not only aware of this suit when he acted as an attorney for ISI, but he represented ISI on matters specifically relating to this case. He is now using the knowledge he gained through an attorney-client relationship against his former client. Certainly he could not appear on his own behalf against ISI. *Chugach Electric Association vs. U. S. District Court*, 370 F.2d 441 (9 Cir. 1966). To allow him to appear through his attorney would be to allow him to do indirectly what he cannot do directly. Holding that Geerlings does not have standing to appear against ISI, however, does not mean that the question of appealability must be disregarded. Since appealability relates directly to our jurisdiction, it is "encumbent upon us to ascertain whether the order of the district court is final and appealable." *Budke vs. Kaiser-Frazer Co.*, 275 F.2d 217, 219 (9 Cir. 1960).

Under Title 28 U.S.C., Section 1291, the courts of appeals have jurisdiction of appeals "from all final decisions" of United States district courts. The historic policy, and the concept of finality on which Appellees rely, is that a "final decision" is one which ends the litigation on the merits and leaves nothing for the court to do but execute the judgment. *Catlin vs. U. S.*, 324 U.S. 229, 65 S.Ct. 631, 89 L.Ed. 911 (1945); *Cobbledick vs. U. S.*, 309 U. S. 323, 60 S.Ct. 540, 84 L.Ed. 783 (1940). Despite its apparent simplicity, however, this definition has not proved workable in all situations. The Supreme Court conceded long ago that the cases on finality "are not altogether harmonious", *McGourkey vs. Toledo & Ohio Central Railway Co.*, 146 U.S. 536, 545, 13 S.Ct. 170, 36 L.Ed. 1079 (1892), and the court stated more recently that it "cannot devise a form of words that will settle this recurrent problem." *Dickenson vs. Petroleum Conversion Corp.*, 338 U.S. 507, 508, 70 S.Ct. 322, 94 L.Ed. 299 (1950).

One group of cases in which the question of finality was considered involves what the Supreme Court has termed "collateral orders." A collateral order is an offshoot of the principal litigation which is immediately appealable as a "final decision" because of the practicalities of the litigation and because it disposes of a matter separate from the merits of the case. The leading case for allowing appeal of a collateral order is *Cohen vs. Beneficial Industrial Loan Corporation*, 337 U.S. 541, 69 S.Ct. 1221, 93 L.Ed. 1528 (1949). That case was a stockholder's suit in which the defendant corporation moved under New Jersey law to require plaintiff to post security for defendant's costs. The motion was denied. In holding that the order denying the motion was appealable, the Supreme Court said at 337 U.S. 546:

> "This decision appears to fall in that small class which finally determines claims of right separate from and collateral to rights asserted in the action, too important to be denied review and too independent of the cause itself to require that appellate consideration be deferred until the whole case is adjudicated."

The Supreme Court, citing *Cohen, supra*, reiterated its practical approach to the question of finality in *Gillespie vs. U. S. Steel Corporation*, 379 U.S. 148, 85 S.Ct. 308, 13 L.Ed.2d 199 (1964). *Gillespie* was a Jones Act case where the district court struck portions of the complaint including the parts relating to recovery for persons other than the decedent's mother. In allowing the appeal from that ruling, the Court stated at 379 U.S. 153:

> "It is true that the review of this by the Court of Appeals could be called 'piecemeal'; but it does not appear that the inconvenience and cost of trying this case will be greater because the Court of Appeals decided the issues raised instead of compelling the parties to go to trial with them unanswered. We cannot say that the Court of Appeals chose wrongly under the circumstances. And it seems clear now that the case is before us that the eventual costs, as all the parties recognize, will certainly be less if we now pass on the questions presented here rather than send the case back with

> those issues undecided. Moreover, the delay of perhaps a number of years in having the brother's and sister's rights determined might work a great injustice on them, since the claims for recovery for their benefit have been effectively cut off so long as the District Judge's ruling stands."

The meaning of the term "collateral" was set out by the Supreme Court in *Mercantile National Bank at Dallas v. Langdean*, 371 U.S. 555, 83 S.Ct. 520, 9 L.Ed.2d 523 (1963). In that case the Texas Supreme Court overruled objections to venue of an action where the action was brought in a venue proper under state law although a federal statute arguably required suit to be brought elsewhere. The Court allowed the appeal, saying at 371 U.S. 558:

> "This is a separate and independent matter, anterior to the merits and not enmeshed in the factual and legal issues comprising the plaintiff's cause of action."

In *Cohen, supra*, at 337 U.S. 546, the Supreme Court spoke of the order denying security for costs as an order which "did not make any step toward final disposition of the merits of the case and will not be merged in final judgment." It seems clear in this case that the order disapproving the proposed settlement is a collateral order. The proposed settlement is independent of the merits of the case. It would not merge in final judgment. Disapproval of the settlement is not a step toward final disposition and it is not in any sense an ingredient of the cause of action. In itself, the district judge's order is final on the question of whether the proposed settlement should be given judicial approval.

The ultimate balance on the question of finality, as the Supreme Court stated in *Dickinson vs. Petroleum Conversion Corp.*, 338 U.S. 507, 511, 70 S.Ct. 322, 94 L.Ed. 299 (1950), is between "the inconvenience and costs of piecemeal review on the one

hand and the danger of denying justice by delay on the other." As a practical matter, stockholder's derivative suits and class actions generally present complex questions and involve large numbers of exhibits and witnesses. The present case is a good example. The trial would be lengthy and expensive. In this situation, therefore, we think that the cost and delay of piecemeal review, as balancing factors, are diminished in importance. The named plaintiffs, as representatives of a class under Rules 23.1 and 23(e), F.R.Civ.P., have a strong duty to fairly and adequately represent the interests of the class. Considering again the length of trial in such cases, the right of the unnamed plaintiffs to fair representation may be infringed by the erroneous disapproval of a settlement. To those parties, the disapproval of a settlement would only delay justice. We think that the inconvenience of piecemeal review of an order disapproving a settlement is outweighed by the danger of denying justice by delay. We hold, therefore, that orders disapproving settlements under Rules 23.1 and 23(e), F.R.Civ.P., are appealable as final decisions under Title 28 U.S.C., Section 1291.

DISAPPROVAL OF THE SETTLEMENT

Rules 23(e) and 23.1, F.R.Civ.P., provide that an action brought under those rules "shall not be dismissed or compromised without the approval of the court." The reason for the requirement is obvious. Because the rights of many persons are at stake who are parties to the action only through their representative, a settlement negotiated between the named parties may not give due regard to the interests of those unnamed. *Cohen vs. Young*, 127 F.2d 721 (6 Cir. 1942). The question for the district judge is whether the proposed settlement is fair and adequate to all concerned. The question on appeal here is whether the district judge abused his discretion in denying the proposed settlement.

Appellants contend that the district judge abused his discretion by failing to directly balance the merits of plaintiffs' claims against the benefits of settlement. We do not agree. Since the exercise of discretion involves essentially a question of fairness, the district judge was entitled to view with more weight the balance between what plaintiffs sought in their complaint and what the settlement provided. Appellants also argue that the proposed settlement should have been accepted because a triangular understanding existed between the parties to this suit and the SEC that both actions would be settled on the same terms. We do not think that the district judge abused his discretion by not accepting the settlement on this basis, especially in view of his findings that the settlement with the SEC was broader than the the proposed settlement of this suit and that the proposed settlement waived plaintiffs' claims to restoration of any part of the alleged excess fees. He was entitled to consider that at least some unnamed plaintiffs did not have such an understanding since certain of them appeared in opposition to the settlement.

The district judge properly understood that his responsibility was to act as guardian of the absent parties and the corporate fund as a whole. As such, he was entitled to consider that the prayer for relief was reasonable and that the settlement, when compared to the relief sought, was inadequate. To hold that no consideration existed for part of the settlement was also proper when the SEC settlement was compared to the proposed settlement of this suit. In short, we find that the district judge did not act arbitrarily or unreasonably under all the circumstances presented by this case. He acted entirely within the bounds of his discretion.

The judgment of the district court is affirmed.

United States Court of Appeals
for the Ninth Circuit

Nos. 23489, 23548, 23582

Lawrence and Elizabeth Norman,
Plaintiffs-Appellants-Appellees,
vs.
R. L. McKee, E. R. Foley, Elwood Murphy, Insurance & Securities Incorporated, W. W. Weeth, W. H. Draper, Jr. and Pacific National Bank of San Francisco,
Defendants-Appellants-Appellees.

Upon reconsideration of the opinion in the above-entitled cause,

It Is Ordered that the opinion filed August 28, 1970, be and hereby is modified by striking the following sentence from the third full paragraph on Page 4 of the slip opinion:

> "He is now using the knowledge he gained through an attorney-client relationship against his former client."

I hereby certify that Judges Browning, Hufstedler and Battin have concurred in the above order. The clerk will please file.

/s/ JAMES F. BATTIN
United States District Judge
Sitting on the Circuit Court
by designation

Dated September 30, 1970

Appendix B

United States District Court
Northern District of California

No. 45079

Lawrence Norman and Elisabeth Norman,
Plaintiffs,

vs.

R. L. McKee, et al,
Defendants.

MEMORANDUM OF DECISION

SWEIGERT, J.

This suit was commenced on May 9, 1966, by the named plaintiffs, Lawrence Norman and Elizabeth Norman, his wife, as investors since 1963 in Insurance Securities Trust Fund against the Fund (which has approximately 175,000 investors); its directors and officers, its Trustee, Pacific National Bank, and its underwriter and manager, Insurance Securities Incorporated (hereinafter referred to as ISI) derivatively on behalf of the Fund and representatively on behalf of all other investors. Jurisdiction of this Court is invoked under the Investment Company Act of 1940 (15 U.S.C. § 80(a) et seq).

The complaint alleges in substance and effect that the defendants, acting in violation of the Act, improperly charged the Fund (a) with brokerage commissions totaling $3,772,000 during the fiscal years ending June 30, 1962, 1963, 1964 and 1965; (b) with advisory fees amounting to $5,369,282 during the fiscal year ended June 30, 1965; and (c) with net creation fees amounting

to $11,539,666 during the same period. The complaint prays that the defendants be required to account for and restore to the Fund these alleged improper charges, totaling in all over 20 million dollars, and further that defendants be required to pay plaintiffs their costs of suit including reasonable attorneys' fees.

The case comes before the court at this time pursuant to a previous order made under Rules 23(a) and 23.1 Fed. R. Civ. P., and dated and filed herein February 21, 1968, requiring all investors in the Fund, as members of the represented class, to show cause on April 3, 1968, why a certain Stipulation and Settlement and Compromise entered into between the named plaintiffs and the defendants and filed and dated herein February 21, 1968, should not be approved by the court and a judgment entered herein accordingly and binding on all members of the represented class who have not noticed their exclusion as permitted in Rule 23.

The matter came on regularly for hearing on April 3, 1968, at which time certain of the represented class appeared to oppose approval of the settlement, among whom were Alma Meyers and Myrtle G. Cromwell, as executrices of the Last Will of Ethel I. Baumbaugh, deceased, a member of the represented class until her death on March 29, 1967. Further hearings were held on April 4th, April 30th, May 24th and the matter was submitted for decision as of June 7, 1968.

During the hearings affidavits of the parties to the action and of appearing members of the class were received, some oral testimony taken and argument was heard. Further, on April 8, 1968, the court, acting on its own motion, requested the Securities and Exchange Commission to appear as amicus curiae. The Commission did so appear through its General, Associate and Special Counsel, by Memorandum filed herein on May 22, 1968.

All parties to the suit and appearing members of the class were given full opportunity to respond to said SEC Memorandum

by oral argument, written briefs and further affidavits, the responding briefs of the named plaintiffs herein and of the defendants herein being filed herein as of May 22nd and May 21st, respectively.

The court agrees with the named plaintiffs and the defendants to the extent of their argument that the court should not lightly disapprove a compromise of litigation.

However, settlement of a derivative and representative suit affects, not only the rights of those actually before the court, but also the rights of many persons not present to speak for themselves. Rules 23(a) and 23.1 place the court in the role of a third party to the compromise or guardian of the absent parties and of the corporate fund as a whole. The absence or silence of investors does not relieve the judge of his duty and, in fact, adds to his responsibility.

The burden is on the proponents of the settlement to show that the settlement is fair and reasonable, having in mind the likely results of the litigation as compared with the consideration received for not going forward with it.

Although compromise, generally speaking, is to be encouraged, and the practical judgment of the named parties advised by competent counsel is entitled to considerable weight, and although the court should not simply substitute its practical judgment for that of the parties, the court, nevertheless, should not approve a settlement which appears on its face to be so inadequate and, therefore, so unfair to the corporate fund or represented class as not to merit judicial approval. With this in mind we examine the various aspects of the proposed settlement.

THE BROKERAGE FEE ISSUE

The proposed stipulated settlement provides that ISI will restore to the Fund amounts charged by it as brokerage commissions from and after July 1, 1967, so far as those charges exceed ISI's

own costs of performing brokerage service—an amount stipulated to be $618,286.72—and, further, that hereafter ISI will itself perform all services in connection with the sale or purchase of portfolio for the account of the Fund at a charge no greater than ISI's own costs of performing such service—such costs to be determined according to a prescribed formula—and, further, that this arrangement will remain in effect for a period of ten years.

It will be noted that under the proposed settlement no part of the brokerage fees charged against the Fund by ISI prior to July 1, 1967 is to be restored to the Fund.

According to the record (See SEC Order of 1/11/68, p. 7, as appended to the Stipulation for Settlement and Compromise filed 2/21/68) brokerage commissions charged by ISI against the Fund amounted to more than six million dollars during the fiscal years 1959-1967. Plaintiffs' complaint, filed May 9, 1966, alleged the amount to be $3,772,000 during the fiscal years 1962, 1963, 1964 and 1965, apparently upon the theory that recovery would have to be limited by the four year statute of limitations. Adding brokerage fees charged after the filing of suit, the total would be over five million dollars.

Assuming the propriety of offsetting against this amount in favor of ISI its actual costs of performing brokerage services,* the recoverable amount of "profit" in the brokerage fees would still be not less than $2,771,307, according to counsel for the named plaintiffs (see Plaintiffs' Brief of 5/22/68, p. 15) and $1,750,000, according to defendants (see Defendants' Brief of 5/21/68, p. 15).

Counsel for the named plaintiffs express the belief (Plaintiffs' Brief of 5/22/68, p. 10) that giving up of claims for restoration

*The propriety of allowing any such offset in favor of ISI is debatable. The Division of Corporate Regulation and Trading and Markets of the SEC took the view that ISI was not justified in charging the Fund a brokerage fee in addition to its regular management fee. (See SEC Order of 1/11/68, p. 8).

of $2,800,000, past "profit" made by ISI on over five million dollars of brokerage commissions charged against the Fund during the limitations period prior to July 1, 1967, is justified by the fact that the settlement, which obligates ISI to refrain for 10 years from charging the Fund for brokerage services (beyond its actual costs) will eventually benefit the Fund to the extent of an estimated ten million a year, i.e., one million a year over a future 10 year period (sic).

The difficulty with this argument is that the Securities Exchange Commission, as early as August 5, 1964, nearly two years before the commencement of this suit, had issued a formal order directing its staff to investigate the ISI practice of charging the Fund with brokerage commissions and had followed through in March 6, 1967, with a private administrative proceeding against ISI to determine whether the charging of these commissions violated the anti-fraud provisions of the Securities Acts or the Investment Advisory Act of 1940. This latter proceeding eventually resulted in the SEC Order of 1/11/68 already mentioned herein.

That Order sets forth a stipulation (p. 2-7) of the facts concerning brokerage commissions charged to the Fund by ISI between 1959 and 1967; also a statement of the reasons (p. 8) for the SEC Division of Corporate Regulation and Trading and Markets determination that it was unjustifiable for ISI to charge the Trust Fund brokerage commissions in addition to the so-called management fee provided in the basic Trust Agreement.

The Order then recites that, although ISI denies any violation of the federal securities laws, it has offered to discontinue, retroactively to July 1, 1967, charging any amounts in excess of its actual administrative cost of the brokerage services performed for the Fund and has consented to the entry of a cease and desist order to that effect—provided the SEC will refrain from making any findings as to whether its past practices violated the federal securities laws.

The Order then recites that the Commission accepts this offer, despite this limitation,* "in view of the unique circumstances of this particular situation and the benefits which will result to the shareholders of the Fund from a prompt disposition of the matter", it being understood, however, that the Commission's acceptance of the ISI offer "in no sense implies that we are persuaded that the activities engaged in, as set forth in the stipulation of facts, did not violate the federal securities laws or that we in any way condone them."

The SEC Order became effective as of January 11, 1968, more than a month before the signing of the proposed settlement of this suit, and will continue in effect retroactively from July 11, 1967 and indefinitely for the future even if the proposed settlement of this suit is disapproved.

It is clear, therefore, that the proposed settlement of this suit on terms of estimated *future* saving to the Fund (retroactive only to July 1, 1967) does not confer any significant benefit on the Fund, its present investors or those who were investors at the time of the alleged violations that has not already been conferred by the SEC cease and desist order.

We are not impressed with the attempt of counsel or the named plaintiffs to present the in futuro terms of the proposed settlement of this suit as better than the SEC Order. In fact, it would seem that in certain respects the SEC Order is better because (1) it continues indefinitely while the proposed settlement is limited to 10 years, and (2) it places an absolute limit on the amount of brokerage costs chargeable by ISI to $350,000 in the years 1968, 1969 and 1970.

Admittedly, the proposed settlement—except for $618,285 ISI profits in brokerage commissions charged since July 1, 1967—waives plaintiffs' claim for restoration of any part of the five

*One of the five members of the Commission dissented on the ground that the Commission should not preclude itself from making findings concerning legal violations.

million dollar brokerage fees charged against the Fund during the 4 year period prior to commencement of this suit and thereafter through 1967.

Just why under these circumstances the named plaintiffs have joined in a presentation to the court of the proposed settlement is not clear.

Counsel for the named plaintiffs do not suggest any weakness in the legal or factual basis for their claim for restoration of the brokerage fees. On the contrary, they say in their Brief of 5/22/68, p. 9: "Contrary to Mr. Lasky we have always regarded the brokerage claims as a very good cause of action with an excellent prospect of recovery".

It appears from the record that before, on and after the date of the SEC Order, the named plaintiffs were just as free to act appropriately for the benefit of the Fund and the class they claim to represent as was ISI free to settle the SEC proceeding against it on terms considered to be in its own interest.

THE MANAGEMENT FEE ISSUE

For its services, including administration, management and investment advice, ISI charges a so-called "Management Fee" of 1½% per year of the face amount of each outstanding investment certificate.

The complaint alleges that ISI, acting in violation of the Act, received management fees of $5,369,282 from the Fund in the fiscal year ended June 30, 1965 and continues to receive such and, further, alleges that such fees were excessive. The complaint prays recovery of the excessive management fees.

The proposed settlement provides that ISI will attempt to effect an amendment providing a new management fee schedule which will be applicable for 10 years after any such amendment. Such new schedule will be applicable, however, only to new investment certificates sold after the amendment. The new schedule will be such that, if it had been applicable to all certificates

outstanding in 1967, the management fees of ISI during that year would have been at least $700,000 less than those actually received.

Plaintiffs predict that this new schedule will reduce management fees, as compared to present management fees, by about $3,500,000 over the 10 year period.

It will be noted, however, that since the new schedule will be applicable only to investment certificates sold in the future, there will be no change, nor any saving, with respect to management fees chargeable to investment certificates now outstanding—whether they were held during the period of alleged excessive management fee charges or not. Thus, a new schedule can benefit only such of the general public as might invest in the future, or perhaps, some present investor who might purchase an additional new certificate in the future.

As a matter of fact, the proposed settlement provision for a new schedule is broad enough to permit a schedule on a net asset value basis (as distinguished from the present contract-price basis) under which even new investors in the future could be no better off as far as the management fee is concerned, than under the fee schedule applicable to all investors in the past.

Here again the proposed settlement waives plaintiffs' claim to the alleged $5,369,282 collected by ISI during the fiscal year 1965 and management fees thereafter collected by ISI.

CREATION FEE ISSUE

ISI charges and deducts from all payments on the sale of a new certificate a so-called creation fee of 8.85%. Similarly it charges and deducts this creation fee on the reinvestment of the proceeds of a matured certificate in a new certificate.

The complaint alleges that ISI received, in violation of the Act, $11,539,666 in creation fees during the fiscal year ended June 30, 1965, and continues to receive them. The complaint

also alleges that these fees were excessive and prays for restoration of the excessive fees.

First, with respect to creation fees on *re*investment the proposed settlement merely provides that ISI will not for 10 years increase reinvestment creation fees beyond the rates fixed by certain agreements made by ISI under which ISI waived creation fees for some reinvestments and reduced the fee to 5% on others. Further, on August 12, 1967, SEC adopted a Rule 11a-1 (17 CFR 270.11a-1) which now prohibits creation fees on reinvestment of the proceeds of matured certificates. It appears, therefore, that the proposed settlement, so far as *re*investment creation fees are concerned, does not provide any observable benefit for the Fund or its investors—past, present or future.

As to creation fees on *new* investments, the proposed settlement in effect reduces for 10 years the creation fee charge from 8.85% to 8.5%. Plaintiffs predict a saving, as compared with such charges in the past, of 5 million dollars over the 10 year period.

This saving, however, will not benefit the Trust Fund (which does not, itself, pay the creation fee) or existing investors—whether they became such during the period of alleged excessive creation fees on new investments or not. The savings will inure to the benefit only of such of the general public as might make new or additional investments in ISI.

PAST INVESTORS

SEC argues that, when fees, including the brokerage fees here in issue, have been illegally collected over a long period from a mutual fund having the characteristics of the Fund here involved, those who were investors at the time the illegal fees, including the brokerage fees, were collected, but who have since disposed of their investment, have a right, recognizable in equity, to share in any recovery as well as the Fund itself, or investors at the time of the restoration or those who become investors thereafter.

SEC points out that the creation fees were collected by ISI from each investor by deducting the percentage from payments made on his investment. Thus, the creation fees were in the nature of commissions paid to ISI by the individual investors and any claim of illegality of such commissions would be the investors' direct personal claim rather than a claim of the Fund itself.

Similarly, SEC points out that although the management fees were charged against the Fund's income or assets, they were separately computed on the basis of each investor's agreement and the amount deducted therefrom. Accordingly, it appears, therefore, that the claim for illegally charged management fees could also be treated as a claim of the investors rather than a claim of the Fund.

As to the brokerage commissions collected by ISI, the SEC recognizes that these fees were charged against the assets of the Fund rather than against the accounts of the individual investors. It argues, however, that in view of the unique nature of the Fund here involved and the certificates therein, investors who were such at the time the brokerage fees were collected by ISI are entitled, nevertheless, to participate in any restoration thereof. Counsel for the named plaintiffs contend that the claim for brokerage fees is derivative on behalf of the Fund and that there is no legal requirement that the settlement should benefit past investors.

If the SEC is correct, the proposed settlement, waiving as it does substantially all of the claim for past allegedly improper charges, certainly provides no significant recovery which could be specifically allocated to investors who were such during the period of the charges but who meanwhile disposed of their interests.

However, we do not think it is necessary to pass upon this question of class participation at this time. Whatever the legal or equitable rights of former investors, it is certainly proper in

connection with an appraisal of the adequacy and fairness of the proposed settlement to consider, not only the Fund, but also its investors who were such during the alleged improper charges and still continue to be such and, of course, all other present investors as well as future investors.

ATTORNEYS' FEES

It will be noted that, although the named plaintiffs in their complaint prayed for a court award of costs including counsel fees, they have now presented a proposed settlement providing that ISI will directly pay a stipulated fee of $250,000 to counsel for named plaintiffs, one half on effective date of the settlement and the remainder within a year thereafter.

In the opinion of the court this is not a good practice because in some cases it could be a factor making for a premature or inadequate settlement of a derivative or class action, especially where, as in this case, the named plaintiff, Lawrence Norman, himself an attorney associated with his present local record counsel, frankly admits that he expects to share in the $250,000 fee. Any proposed settlement should be presented in terms of the gross consideration to the Fund or class and the matter of attorneys' fees left for judicial determination and award.

Upon a consideration of the whole record, this court agrees with the conclusions reached by SEC to the effect that for the reasons set forth above, the proposed settlement is so inadequate, and, therefore, so unfair that it should not receive judicial approval.

It is therefore ordered that the proposed settlement, as now presented, be disapproved.

Dated: July 29th, 1968.

/s/ W. T. SWEIGERT
United States District Judge

Appendix C

Although the Administrative Office of the United States Courts does not currently maintain statistics reporting class actions as such, other statistics in its annual report are revealing in this connection.

A substantial portion of class actions are actions brought under the federal antitrust or securities laws. In 1970, 929 antitrust actions and 1,211 actions under the securities acts were filed, representing an increase of 121 and 353 per cent, respectively, over the number of such actions filed in 1961. (Annual Report of the Director, Administrative Office of the United States Courts, 1970, herein referred to as Report, p. II-29)

With respect to the load of cases in the District Courts generally, the Report states:

> "During the early years of the 1960's, the number of cases in the district courts eased upward on a modest scale of two to four percent per year. However, the volume of incoming business shot up 8 percent in 1969 and thirteen percent in 1970; thus the additional caseload growth in the decade's last two years outweighs the combined increase of the previous eight.
>
> "What this means in the next five years is that we can anticipate a continued strong growth for the incoming caseload. This can be forecast on the basis of the last ten years. The forecast for 1975 is for a little more than 144,000 cases filed in the United States district courts—compared with about 125,000 filed in the current fiscal year." (Report, p. II-1)
>
> "The 1970 increase in case filings was the steepest caseload jump for any year of the last decade. A total of 127,280 civil and criminal actions were commenced, 13 percent more than fiscal year 1969.
>
> "Terminations have not managed to keep pace with the filings. In 1970 the overall total of 117,254 civil and criminal cases closed represented an 11 percent increase over 1969.

> The slower pace in terminated cases inescapably forced the volume of pending cases up. On June 30, 1970, there were 114,117 civil and criminal cases pending, 10 percent more than a year ago and 66 percent greater than the 68,942 pending on June 30, 1960." (Report, p. II-23)

Directly pertinent to the issue involved here are the statistics respecting the number of trials held in the District Courts. Total civil trials alone increased from 6,260 during 1962 to 9,449 during 1970, an increase of 41 per cent. (Report, p. II-55)